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ABSTRACT

This report addresses the dollar savings described in the Government Accounting Office's (GAO) report supporting direct lending as opposed to the present guaranteed student loan program. The critique explains the changes in the GAO model assumptions and projections that are believed necessary to move from the original $4.8 billion savings to a more reasonable figure. The new figure reflects: (1) 1992 amendments to the Higher Education Act; (2) the current interest rate and inflationary outlook; and (3) more reasonable assumptions about how the shift to direct lending will affect financial markets, educational institutions, student behavior, loan flows, and processing and servicing activities. The updated and revised estimates suggest that the shift from the current guaranteed student loan program to direct lending would generate essentially zero budgetary savings; in fact, it suggests that a $13 million loss, in present value terms, over the 5-year budget period could be experienced. (GLR)

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Direct Government Lending

The Bottom Line

A Critique of GAO's Report on Guaranteed Student Loans Versus Direct Lending and Revised Savings Estimates

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Spring 1993

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Direct Government Lending

The Bottom Line

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ERNST & YOUNG

GAO's report on guaranteed student loans versus direct lending: critique and revised estimates

The November 1992 report from the General Accounting Office (GAO), Student Loans: Direct Loans Could Save Billions in First Five Years with Proper Implementation, admits forthrightly and explicitly that its estimate of savings associated with switching from a guaranteed student loan program to direct lending is very vulnerable to changes in the underlying assumptions in its model: "The values we assume for certain key variables strongly influenced our estimate of the savings achievable from direct lending." (See page 20.) GAO's choice of assumptions, we believe, woefully underestimated certain costs associated with moving from the current guaranteed student loan program, now known as Federal Family Education Loan Program (FFELP), to a program of direct lending.

After correcting for these underestimates of cost and updating the GAO model to reflect more recent CBO interest rate and inflationary projections, as well as the new legal environment, the estimated savings, in present-value terms, for the first five years of a direct-loan program are reduced substantially. Indeed, under alternative—more realistic—assumptions regarding the impacts on service costs, default rates, and financial markets, the shift from guaranteed student loans (FFELP) to direct lending (DL) could actually result in a small net loss over the first five years of the program.

This memorandum, prepared for USA GROUP, explains the changes in the model assumptions and projections that we believe are necessary to move from the original $4.8 billion savings estimate in the GAO report to a more reasonable "bottom-line" figure that reflects: 1) 1992 amendments to the Higher Education Act; 2) the current interest rate and inflationary outlook; and 3) more reasonable assumptions about how the shift to direct lending will affect financial markets, education institutions, student behavior, loan flows, and processing and servicing activities. *The updated and revised estimates emerging from our analysis suggest that **the shift from the current guaranteed student loan program to direct lending would generate essentially zero budgetary savings** (more precisely, a $13 million loss, in present-value terms) over the five-year budget period.*

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Updates for 1992 amendments and current interest rate/inflation projections

The current interest rate projections and the 1992 amendments to the Higher Education Act . . . result in a $1.1 billion decline in projected net savings.

The 1992 amendments to the Higher Education Act reduced the special allowance payment factor, revised the student interest rate structure on Federal Stafford, Federal SLS, and Federal PLUS loans, and changed eligibility requirements and the size of these loans. Some of these changes tended to decrease the savings the GAO projected for direct lending, while others had a partially offsetting impact. The net result from these changes in the law was to decrease the expected savings from switching to direct lending.[1]

In addition, GAO relied on CBO's January 1992 forecast of 91-day and 52-week T-bill rates, 10-year Treasury rates, and changes in the urban Consumer Price Index (CPI). Current forecasts from CBO are, in all cases, considerably lower.[2] Lower interest rates tend to reduce the interest benefits and special allowance payments of the FFELP and reduce the absolute magnitudes of the cost of funds, borrowers' interest payments, and interest benefits in the DL program. Lower inflation rates reduce future servicing costs of both the FFEL and DL programs relative to those in the GAO report. Lower long-term rates also reduce the discount rate so that the future cash flows are not discounted as much relative to present cash flows.[3]

By using the current interest rate projections and the 1992 amendments to the Higher Education Act in the GAO model, the net present-value costs of both the FFEL and DL programs increase. These changes result in the projected net savings from switching from the FFELP to direct loans declining by $1.1 billion—from $4.8 billion to $3.7 billion. (See Column 1 of Table 1.)

Note that to this point in our analysis, the only changes we have made in the assumptions underlying the GAO model are those reflecting updates in the legal environment and the interest rate/inflation environment. These updated assumptions are continued in our subsequent analysis.

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[1] These changes and their impacts were reported on page 30 of the November 1992 GAO report but were not reflected in the title or text of the report.

[2] The source for the current forecast, with the exception of that for the one-year Treasury rate, is "The Economic and Budget Outlook: Fiscal Years 1994-1998," CBO, January 1993. The one-year rate is an unpublished interpolation made by CBO based on the January 1993 forecast. In all cases, the numbers have been extended past the 1998 CBO forecast horizon per the method used by GAO. That is, for all of the series the 1998 value is assumed for each year thereafter.

[3] The number derived from the GAO analysis is not the same as that which would be scored in the budget resolution under current credit budget accounting rules. The GAO analysis is based on a calculation of the net present value of all future cash flows associated with the loans made in fiscal years 1994-1998. Under current credit budget rules, a portion of the lenders' long-term administrative costs are included in the current subsidy (on a present-value basis) calculated for the FFELP, but the administrative costs of a direct loan alternative would be treated on an annual cash basis—thus failing to include administrative costs in years beyond the budget horizon. This credit budget treatment, therefore, creates a bias that overstates the savings from a direct-loan program. While the GAO analysis has several deficiencies, described in this memo, it has at least avoided this problem.

Underlying assumptions on student and institutional behavior

The GAO model contains certain assumptions that appear overly optimistic in their view of how educational institutions, servicers, students, financial markets, and the Department of Education (ED) operate in the current FFELP environment and how they will adjust to the DL program.

With revised, more accurate service charge assumptions, the estimated savings for DL are reduced another $1.9 billion.

■ **Servicing costs — I:** We believe that GAO's estimate of the servicing costs for the DL program are improperly structured. A more accurate specification, based on the actual processing costs of USA GROUP's servicing affiliate, would be 0.65 percent annually during the in-school period and 1.67 percent during the repayment period. This structure has a higher overall average than the 1.0 percent rate used by GAO, but is slightly lower than the 1.46 percent recommended by KPMG.[4] GAO's assumption, which is heavily influenced by the costs of the Student Loan Marketing Association (Sallie Mae), is too low for at least three reasons:

- The Sallie Mae loan selection process, taking loans primarily from institutions that have the best documentation, high loan balances, long repayment periods, and histories of low default rates, results in a kind of "cream skimming" that reduces servicing costs.
- This "clean" portfolio not only reduces Sallie Mae's documentation and collection costs, it allows them to undertake processing procedures that maximize economies of scale—scale economies not available to servicers that must process a wider range of loans.
- Sallie Mae's internal cost estimates do not include a profit factor that a private service provider would charge.

With revised, more accurate service charge assumptions, the estimated savings for DL are reduced another $1.9 billion. (See Column 2 of Table 1.) The magnitude of this change is consistent with the Sensitivity Analysis in Appendix II (page 20) of the GAO report.

The GAO model appears to ignore certain activities currently undertaken by guarantors. Incorporating these expenses into the model reduces the projected savings by another $1.2 billion.

■ **Servicing costs — II:** The servicing costs above cover only the processing activities of the lender and secondary markets. The GAO model appears to ignore certain default prevention activities, training for school personnel, and collection management functions currently undertaken by guarantors. Under the DL program, the responsibility for these functions would fall on the educational institutions, service contractors, or the Department of Education. We would expect that the government would bear these costs directly or increase the loan origination payment (over and above GAO's assumed amount of $35 per loan strictly for basic origination functions) to compensate the institutions for their added responsibilities.[5] According to USA GROUP, the cost

[4] Letter to the Honorable William D. Ford, December 7, 1992.

[5] A private loan servicing agency would clearly charge for such services. Requiring educational institutions to bear some of this burden could be accomplished under the current FFELP; thus it should be factored out in the analysis for an "apples to apples" comparison.

of these activities, in present-value terms, could be estimated conservatively as a one-time additional charge of 1.38 percent of the average loan, or $46 per loan. Incorporating these expenses into the model reduces the projected savings by another $1.2 billion. (See Column 3 of Table 1.) Again, this order of magnitude is consistent with the Sensitivity Analysis in Appendix II of the GAO report.

■ **Default rates:** The GAO model assumes the switch from FFELP to DL does not affect the default rate. It is difficult for an economist to accept that removing from the system the private-sector players whose returns depend on their success in keeping borrowers in active repayment and preventing defaults will have no impact on the default rate. Various participants in the current FFELP share this skepticism.[6] Our understanding is that other educational loan programs, such as the Federal Insured Student Loan ("FISL") Program and the Perkins Loan Program (previously called both the National Defense Student Loan Program and the National Direct Student Loan Program), where guarantors are not part of the process, have much higher default rates than Federal Stafford, Federal SLS, or Federal PLUS. In addition, lenders and guarantors in the current FFELP screen out schools that collect tuition payments for marginal instruction, which, the GAO has concluded, the Department of Education "has failed to weed out."[7] Accordingly, we have raised the assumed default rate on the DL program by a very modest amount—one percentage point—higher than that of the FFELP. The net result of this change is to reduce the savings for direct lending by another $500 million. (See Column 4 of Table 1.) Since the GAO report did not consider such a change of assumptions in its Sensitivity Analysis, we cannot report whether the change is consistent with the GAO analysis.

Removing private-sector players whose returns depend on preventing defaults will have impact on the default rate. We have raised the assumed default rate on the DL program by a very modest amount—one percentage point. The net result of this change is to reduce the savings for direct lending by another $500 million.

■ **Financial market/interest rates:** GAO assumes that, under the DL program, the Treasury can increase its net annual issuance of 10-year Treasury securities by about $12 billion—roughly doubling that issuance in this maturity category—with no impact on market interest rates. On the contrary, to the extent that there are so-called "financial market segmentation effects" and to the extent that Treasury securities are not perfect substitutes for government-guaranteed securities, investors will demand some additional return to increase their holdings of Treasury securities.[8] Interest rates will adjust. We assume a five basis-point increase in the 10-year Treasury security rate under the DL alternative. (Note that we do not change the discount rate.) The result of this interest rate change is to reduce estimated savings for direct lending by an additional $100 million. (See Column 5 of Table 1.)

Investors will demand some additional return to increase their holdings of Treasury securities. Interest rates will adjust. This interest rate change [will] reduce estimated savings for direct lending by an additional $100 million.

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[6] See the focus group responses (pages 7-10) in the November 1992 GAO report and "Direct Lending: A Review of Critical Issues," by John Lee, to be published Spring 1993.

[7] See paper of John Lee, p. 8, and GAO High-Risk Series, *Guaranteed Student Loans*, December 1992, pp. 8, 16-17, 21-22.

[8] Because of legal and behavioral restrictions, certain borrowers have preferred maturity ranges for their investments. This leads to a phenomenon known as market segmentation, where the rate of interest for a particular maturity is influenced by the relative supply and demand conditions for that maturity. Thus, doubling the supply of 10-year Treasury securities would be likely to have a measurable influence on 10-year interest rates even if the relative increase in the supply of all Treasury securities is much smaller. This analysis conservatively assumes the five basis-point premium necessary to induce investors to increase their holdings of 10-year Treasury securities affects only the net new issues of such securities, and not the total of such securities. Note also that if Treasury were to finance the DL program with securities of other maturity categories—as GAO indicated in its rebuttal to KPMG—then it would be undertaking greater interest rate risk. GAO does not consider such interest rate risks in its analysis.

Together, these changes in assumptions entirely wipe out the savings projected by GAO. **According to our estimates, reflecting more current interest rates and inflationary expectations as well as more realistic expectations about servicing costs, default rates, and interest costs, the switch from the guaranteed student loan program to a direct loan program generates no net budgetary savings—or, more precisely, generates a net budgetary loss of $13 million, in net present-value terms, in the first five years.**

Together, these changes in assumptions entirely wipe out the savings projected by GAO. The switch from the guaranteed student loan program to a direct loan program generates no net budgetary savings—or, more precisely, generates a net budgetary loss of $13 million in the first five years.

It should be noted that our revised estimates do not change GAO's estimate of the costs of transition from the FFELP to direct lending. Several industry experts have criticized GAO's figure as extremely low. They indicate that a change as radical as the switch to DL would cause many lenders, guarantors, and institutions in the current FFELP to react in ways that would leave the government with greater administrative responsibilities, higher default rates, and larger losses on outstanding FFELP loans. Thus, the total losses associated with the shift to direct lending would be larger than those estimated above.[9]

Finally, it also should be noted that there are savings that potentially could be achieved in the current FFELP. Identifying and calculating the magnitude of these savings is beyond the scope of this memorandum. Rather, we concentrate exclusively on the structure and assumptions in the GAO model to evaluate the switch from the FFELP to direct lending. Nevertheless, from a policy perspective, it would be prudent to consider potential modifications in the existing system that would lead to cost savings, streamlining of the system, and meeting the needs of the national service program before moving to an alternative as radical as a complete overhaul and shift to direct lending. Only after it is determined that the less radical and less risky changes in the existing system cannot achieve the budgetary and policy goals should the direct-lending approach be viewed as the more viable alternative.

From a policy perspective, it would be prudent to consider potential modifications in the existing system that would lead to cost savings, streamlining, and national service before moving to an alternative as radical as a shift to direct lending.

[9] We also considered making other changes in the GAO model to better reflect reality. Such changes would incorporate more realistic figures for cancellation rates, payout rates, and recovery rates (after initial default). On net, these changes would increase the estimated costs of direct lending more than the estimated costs of the FFELP. Thus, the analysis in the text above, if it did incorporate more realistic estimates of transition costs, would still be likely to understate the net budgetary loss associated with a switch to direct lending.

Estimated Savings (Losses) in Switching from FFELP to DL

Table One

Simulation:	**1**	**2**	**3**	**4**	**5**
Assumptions:					
CBO forecast	Updated to 1993	Updated to 1993	Updated to 1993	Updated to 1993	Updated to 1993
1992 HE Act Amendments	Included	Included	Included	Included	Included
DL Servicing Costs	Same as GAO	Stafford: 0.65% (in-school) 1.67% (repay.) SLS/PLUS: 1.67% (in-school) 1.67% (repay.)	Stafford: 0.65% (in-school) 1.67% (repay.) SLS/PLUS: 1.67% (in-school) 1.67% (repay.)	Stafford: 0.65% (in-school) 1.67% (repay.) SLS/PLUS: 1.67% (in-school) 1.67% (repay.)	Stafford: 0.65% (in-school) 1.67% (repay.) SLS/PLUS: 1.67% (in-school) 1.67% (repay.)
DL Default Prevention and Collection Servicing Costs	Same as GAO	Same as GAO	+$46 to cover related expenses	+$46 to cover related expenses	+$46 to cover related expenses
Default rate for DL	Same as GAO	Same as GAO	Same as GAO	+1.0%	+1.0%
10-year Treasury note rate	Same as GAO	Same as GAO	Same as GAO	Same as GAO	+0.05%
Resulting Savings (billions)	**$3.670**	**$1.788**	**$0.584**	**$0.099**	**($0.013)**

Source: GAO, CBO and Ernst & Young March 1993

Direct Government Lending:

The Bottom Line on Savings

(in billions)

Chart One

The General Accounting Office's estimate of dollars saved in switching to direct lending from the current Federal Family Education Loan Program (FFELP) is $4.8 billion over the first five years.

The cumulative effect of factoring in several updated economic and program-management assumptions reduces those purported savings to less than zero.